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SEPARATION OF STATE AND LOCAL REVENUES

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The history of American state finance in the last thirty years reveals two major movements, one against excessive uniformity, the other against excessive decentralization. It has been found on the one hand that a uniform rate of taxation cannot successfully be applied to all forms of property, and we have the irresistible movement for classification of taxes. It has been found on the other hand that inter-community enterprises or property cannot successfully be taxed by local officials, and we have the inevitable movement towards central assessment and the emergence of the state tax commission.

Surveying these movements, many students of taxation have essayed to project them into the future—always a necessary but a difficult and dangerous thing to do. These prognosticators have evolved as their ideal the separation of the sources of state and local revenues, which Professor Seligman would extend to cover the federal as well as the field of commonwealth finance. The tax whose base is broad is to be given to the superior jurisdiction; the tax whose base is narrow is to be used exclusively by the local jurisdictions. Concretely, in state finance the central government is to take over the tax on insurance companies, on railroads and similar enterprises carried on in all or nearly all parts of the state. The local governments are to be given for their exclusive use the general property tax, with an indefinite measure of home rule, so that they may abolish or modify the tax on personal property. The proposition apparently is that no tax shall be used in common but shall belong exclusively to the jurisdiction to which it has been assigned.

Much of this program is obviously sound and in strict accord with fundamental tendencies, the reality of which cannot be questioned. The only difficulty is to determine its proper limits. Some seven years ago at the first meeting of the National Tax Association¹ the writer suggested that this program, as it was then generally for-

¹ *State and Local Taxation, First National Conference under the Auspices of the National Tax Association*, vol. i, p. 514.

mulated, was extreme, and likely to result in as much harm as good, if not carefully guarded. And events since that time have apparently warranted the position then taken. Professor Seligman, for instance, a few years ago, expressed his approval of "a separation of state and local taxation, with local option on the part of the localities to tax or to exempt from taxation whatever classes of property they saw fit."² At the present time Professor Seligman approves of only a very narrow measure of home rule. Other advocates, who a few years ago endorsed the whole program of separation without modification, now suggest the retention of at least a small state tax on general property in order to avoid the danger of extravagance, which unquestionably accompanies the program. The chief danger, however, lies in the possibility that the reaction against the iron rule of uniformity under which most states have labored in the past, may prove excessive and extreme. The principal error of the "separatists," as the writer views it, lies in the proposal or implication utterly to divorce state and local tax jurisdictions.

That there is justice in the demand for some measure of local fiscal freedom, I would be the last to deny. It is now generally recognized that no tax is fit to be applied to all kinds of property and business. By the same token no tax is fit to be applied to all of the diverse territorial districts of the same state. In the average American commonwealth today we have every variety of social life from the city slum to the frontier. This is true even in some of the original thirteen states. We must have territorial classification for the same reason that we must classify the subjects of taxation. One way to establish such territorial classification is by carefully limited local home rule under such regulation that it cannot be abused. Thus the local governments could not safely be given the right to impose new taxes on business as they see fit. Business is now divided among so many jurisdictions that to give each the right to devise new methods of taxing it is merely to invite double and multiple taxation. But the various local districts might safely be given the right to exempt specified classes of personal property and even to select from a small number of specified local taxes, set aside for their potential use by the state legislature.

But the element of centralization is just as essential as the element of local autonomy, and much more necessary at the present

² *Political Science Quarterly*, vol. xxii, pp. 312-313.

time. This is particularly true with respect to tax administration. In no domain of public administration are distance, removal from local pressure and local political intrigue, so important as in tax administration. The strength of the assessor is as much increased by outside protection and control as it is weakened by lack of local knowledge. In short, we must have a mixture of local and central control in tax administration.

Many advocates of separation find their ideal in the present divorce of federal from state taxation. Federal taxation has its elements of strength because of this very divorce, but it has its elements of weakness as well, arising from the same origin; and federal taxation would be stronger if it were linked up more closely with state taxation. The administration of the federal inheritance tax during the Spanish War was woefully weak in many respects. Many estates subject to the tax escaped because of the lack of local knowledge. Merely to enforce a federal inheritance tax properly would require the federal government to duplicate administrative machinery which the state governments already possess. On the other hand, at the present time state inheritance taxation is suffering greatly from the lack of control by a superior and higher jurisdiction. All this illustrates the principal truth which it is desired to emphasize here, that the ideal is not separation but joint administration and control; that we could not divorce state and local taxation even if we tried, and we ought not even if we could. The central administration needs local knowledge. The local administration needs backing and control from the central body. Any other plan involves duplication of machinery and excessive cost of administration.

Let me illustrate: There is a widespread notion that the federal government controls interstate commerce and many court decisions have been rendered, which apparently prevent the state governments from taxing the earnings of interstate commerce. But the property of going business concerns, and its earnings, are inseparable. The same property to a successful business concern is worth more than to an unsuccessful business concern, and the state governments taking advantage of this truth have so imposed and defined their property taxes as to touch and tax earnings from interstate commerce. Again a state income tax on earnings derived from interstate commerce might be unconstitutional. But I do not see, under the rulings of the federal courts, how the states could be prevented

from using an excise tax or something akin thereto, measured by or with respect to earnings derived from interstate commerce. The proposition of exclusive jurisdictions fails. Joint and harmonious control is the only true solution.

Moreover, it may be denied in the most emphatic way that it is necessarily a bad thing for two jurisdictions to use the same tax. If the tax rate is already high, it may be unwise for another jurisdiction to clap on a sur-tax. And there are other circumstances in which it would be palpably unwise for two jurisdictions to use the same tax. But just as frequently it is a good thing for two branches of government to use the same basis of taxation. Local criticism helps the central authority to be efficient, and central criticism helps the local administrator to be effective. This is particularly true of the income tax. Central control is needed to prevent double taxation and to protect the fearless assessor; local knowledge is absolutely indispensable to prevent evasion. The federal income tax would be stronger if every state in the union had a state income tax, provided of course that the two administrations worked in harmony and that the aggregate rate were not excessive. The development of the income tax in Europe plainly proves this point. And anyone who has administered an income tax must realize its truth regardless of historical or practical confirmation.

The same is true of the taxation of real estate. Many large manufacturing plants are located in small villages which cannot afford to employ an assessor expert enough to value such property. The cheap way is to have a corps of expert assessors for the whole state. Here are two low grade iron mines side by side. The operating company in the one case has valuable connections with iron furnaces and large consumers and because of this fact it can operate the mine at a profit. The other company has no such connections and cannot mine its ore profitably. How are the two mines to be assessed; and what local assessor is fitted to handle such difficult cases? Again in some thinly settled districts there are mines or large manufacturing plants the taxation of which frequently supplies more money than the local district can utilize wisely. All these things call for intimate linking up of the central and local jurisdictions.

In the writer's opinion it is idle and academic—in the worst sense—to say that we can have general or central supervision over local taxes without the central jurisdiction making active use of the

same basis of taxation. Theoretically, yes—practically, no. What local government in the United States would brook continual control and supervision by a state body which had no vital or real interest in the taxes and assessments concerned? On the other hand, what American legislature would make the appropriations necessary to maintain an effective central commission unless that commission were actively engaged in supervising assessments which the state government itself was to utilize?

The same line of thought applies to the "state equalization." Much fun has been poked at this in the past, because in most places the state equalization was made by an *ex officio* board which had no serious interest in, and no real knowledge of, the work it was called upon to perform. But just as soon as the state equalization is undertaken seriously it becomes the opening wedge of tax reform. In a large number of states in which the greatest improvement in tax administration has been made in the last five years, the necessity of making a state equalization has proved the beginning of tax reform. The knowledge acquired in this work is exceedingly valuable to local officials and frequently can be obtained in no other way.

Both the state and local governments need to use the same basis of taxation not only to secure administrative coöperation, but also to prevent extravagance on the part of the state government. To give the taxation of the large corporations exclusively to the state government for its support is good neither for the corporations nor for the state government. It concentrates corporate influence at the state capitol. If the corporations are unusually strong they may be powerful enough to keep state expenditures down and thus get off with an unfairly small share of the general tax burden. If they are weak, special corporation taxes may be pushed unjustifiably high and the state government spend too much money. Above all things, the state government needs the criticism and check that come from the the farmer, the home owner and other small taxpayers, who constitute the majority of the electorate. To deprive this class of its immediate interest in the expenditures of the state government is openly and deliberately inviting extravagance.

This last assertion is probably proved by the financial history of the last decade. I cannot speak with certainty because statistics are not available, but I venture to predict that when the next census volume on wealth, debt and taxation appears, contrasting

state expenditures in 1913 with those in 1902-1903, it will be found that the increase in expenditures has been greatest in those states which either have achieved separation or have approached it most closely. New York, California, New Jersey and the other states in which separation has been most nearly achieved will be found, I believe, greatly to have outstripped their competitors in rapid expenditure.

This is the deepest vice of separation—it does not separate. When the sources of revenue are segregated, the state government is apt to find itself for a short period on “Easy Street,” with ample revenue easily secured. But the spending ability of the average state legislature is great and within a short time the new sources of revenue are likely to be exhausted and the state legislature to find an irresistible temptation to lay on a small state tax once more. Substantially this has happened in New York and California. It is irrelevant to say that in these cases the state tax has been necessitated by extraordinary expenditures. The answer is that the absence of a state tax levy invites such expenditures.

Finally it should be noted that neither experience nor theory warrants the belief that the mere abolition of a state tax will greatly improve assessment work. In the tax bill of the average American taxpayer the state tax accounts for only 11 per cent of the total. The remainder, 89 per cent, represents county and local taxes, and it is primarily to avoid these that the assessor is subjected to the pressure which so frequently makes his work inefficient. Many, if not most, of the states which have made marked improvement in assessment work during the last five years are states with a comparatively high state tax and using the device of state equalization. Arizona, Colorado, Minnesota, Michigan, Ohio, West Virginia and Washington are merely some of the states without “separation” which have greatly improved their assessment work in the past five years. In Wisconsin for a number of years the state tax practically disappeared. During those years little improvement was marked in the local assessments. Later the state tax was increased and the local assessment work rapidly improved. The city of Milwaukee went to a full value basis in the latter period when the state tax was quite an important factor. In states like Maryland and Virginia where there is no central control³ or state equalization and where the ratio of true to as-

³ In Maryland, since the recent establishment of a strong state tax commission, this is no longer true.

essed value varies from twenty to ninety per cent among the various counties, the imposition of a high tax is obviously an important factor in demoralizing local assessments. But what these states need is not separation but central control. Pennsylvania has had something akin to separation for many years. The quality of its local assessment work is, from all the writer can learn, below rather than above the average.

If space permitted it would be desirable to point out in detail that for the state government to take over enough sources of revenue to accomplish separation would in the average state deprive the local government of property or other sources of taxation which they cannot afford to spare. A realization of this fact, I understand, prevented a recommendation of separation in the recent admirable report of the Kentucky tax commission. The truth is that while there is no very rigid or exact connection between the property within a given jurisdiction and the necessary governmental expenses of that jurisdiction, there is a very real connection of this kind which cannot be wholly disregarded. There is more reason perhaps for the retention by the state government of all taxes on steam railroads than in the case of any other form of property or industry. But even in this case serious injury may be done to particular local jurisdictions. Take a small city or village in which important railroad shops are located: They may constitute and frequently do, a large part of the property of this place, and the principal expenses of the local government may arise from the provision of proper schooling and fire protection for the district occupied by the railroad shops. To deprive this jurisdiction of all taxes from this source is inequitable and unwise. In short, while there are some taxes, including that on steam railroads, which are particularly adapted to state use, modifications and exceptions must be made even with reference to this tax and when we further extend the sphere of exclusive state taxes we almost always encounter serious trouble.

In conclusion I may be allowed to quote a summarized statement of this problem written seven years ago. Since that time I have watched the development of tax administration carefully and its trend during the last seven years seems strongly to confirm the opinions expressed at that time. There is one possible exception to this. The progress of centralization, and in particular the extension of powers of the state tax commission, will possibly receive a tem-

porary check in the next few years. This merely means that the task of introducing efficiency, certainty and equity into local assessments is an unpopular and difficult one. There is every confirmation of the proposition that to accomplish such a reform there must be (except for large cities) a large element of outside pressure emanating from central authority, such as a tax commission. But owing to the rapid expansion in expenditures during the last few years and the consequent increase of taxes, the progress of this reform will possibly be slightly checked in the near future. The movement is inevitable, however, and in due course will take its way forward. The summarized statement made several years ago at the first meeting of the National Tax Association follows:

1. The state legislature should, in my opinion, without reference to the local divisions and without respect for impossible plans of local fiscal democracy, abolish the personal property tax and introduce a substitute therefor, if one can be devised.

2. If this is impracticable, they should introduce at once some scheme of limited local option which will permit particular districts to abolish the personal property tax. No plan should be entertained, however, which will interfere with central supervision of assessments and central control over county equalizations.

3. This carefully limited measure of local option should be introduced without reference to the separation of state and local revenues.

4. Similarly, the question of what sources of revenue should be retained by the state ought to be settled absolutely on its merits without reference to home rule, by a careful study of tax jurisdictions and the connection between property or business and the expenses of local government. Doubtful points should be decided in favor of the local jurisdictions; and equitable apportionment should not be strained one inch in order merely to supply the state with revenue enough to get along without the levy of direct property taxes. If, after the apportionment of sources between state and local governments, the state has not sufficient special revenue to pay its expenses, let the deficit be raised by a state tax upon real estate, including in real estate the corporate and commercial values assigned to the local governments. The evils of an equalization based upon real estate are less than the evils of the unconscious, haphazard equalization involved in the retention by the state of a number of revenues which more logically belong to the local divisions.

5. Finally, I assert with some confidence, that if the equalization is confined to real estate, and if it is made by an efficient tax commission which takes its work seriously, it is not a curse but a blessing. In the first place, the payment of some direct state tax stimulates the interest of the citizen in the expenditures of the state government. In the second place, the equalization can be made, with all necessary accuracy, so accurately in fact that no fair-minded

person, after studying thoroughly the conditions of the problem, will question its substantial accuracy as between county and county. It can be made without prohibitive expense—it is not necessary, as is sometimes asserted, to reassess every parcel of real estate in the commonwealth to get at the truth. And in gathering the data upon which to base its conclusions, the tax commission will obtain indispensable information concerning local assessment work, besides securing material absolutely necessary for the proper performance of the work of county equalization. The county equalizations are, in the aggregate, more important than the state equalization; but at the present time they are woefully inaccurate. The county officials who make these equalizations are, as a rule, destitute of reliable data upon which to base their apportionments, and, like the local assessors, they will never do their work efficiently until they are forced to do so by central supervision and state aid. Reform in these matters must come from without.